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No. 08-164

In the Supreme Court of the United States

VISION SERVICE PLAN, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTION PRESENTED

Whether petitioner qualifies for exemption from federal income tax as a "social welfare" organization within the meaning of 26 U.S.C. 501(c)(4).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-3a) is not published in the *Federal Reporter* but is reprinted in 265 Fed. Appx. 650. The opinion of the district court (Pet. App. 4a-25a) is not published in the *Federal Supplement* but is reprinted in 2006-1 U.S. Tax Cas. (CCH) ¶ 50,173.

JURISDICTION

The judgment of the court of appeals was entered on January 30, 2008. A petition for rehearing was denied on April 9, 2008 (Pet. App. 26a). On June 19, 2008, Justice Kennedy extended the time within which to file a petition for a writ of certiorari to and including August 7, 2008, and the petition was filed on that date. The ju-

risdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Section 501(a) of the Internal Revenue Code exempts from federal income taxation certain organizations, including those described in Section 501(c)(4), *i.e.*, organizations "not organized for profit but operated exclusively for the promotion of social welfare." 26 U.S.C. 501(a) and (c)(4)(A). Under Treasury regulations implementing Section 501(c)(4), an organization is operated exclusively for the promotion of social welfare "if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community." 26 C.F.R. 1.501(c)(4)-1(a)(2)(i). An organization is not operated primarily for the promotion of social welfare, however, if "its primary activity is * * * carrying on a business with the general public in a manner similar to organizations which are operated for profit." 26 C.F.R. 1.501(c)(4)-1(a)(2)(ii).

2. According to petitioner's articles of incorporation, its purpose is to "defray and assume the costs of professional vision care, by establishing a fund from periodic payments by subscribers or beneficiaries, from which fund said costs may be paid." S.E.R. 17. Petitioner's primary activity consists of contracting with employers, health maintenance organizations (HMOs), insurance companies, and political subdivisions (collectively, subscribers) to arrange for the provision of vision-care services and vision supplies to subscribers' employees or members (collectively, enrollees). E.R. 5; S.E.R. 24-25. Petitioner arranges for those vision-care services and supplies, which generally include an eye examination and a prescription for lenses, to be provided to enrollees

by independent vision-care professionals (participating providers) such as optometrists. S.E.R. 25-26. Petitioner itself, however, does not employ any providers or directly deliver vision services. Pet. App. 15a; S.E.R. 162-163.

Petitioner operates a prepaid vision-care program and a self-funded program, both of which require subscribers to pay an administrative fee. S.E.R. 42-44. Under the prepaid program, the subscriber agrees to pay a fixed monthly amount to petitioner, in return for which the subscriber's enrollees are entitled to receive certain contracted-for vision-care benefits from petitioner's participating providers. S.E.R. 42-43. Under the self-funded program, also known as the Administrative Service Plan, petitioner provides administrative services, such as processing and paying claims, in exchange for an administrative fee. Petitioner ultimately receives reimbursement from the subscriber, however, for any claim that is incurred by the subscriber's enrollee. S.E.R. 43; E.R. 4-5.

Most of petitioner's enrollees are employed by its large subscribers, each of whom has 1000 or more employees. E.R. 54. Members of the general public cannot receive petitioner's services without being an employee or member of an employer, political subdivision, or other group under contract with petitioner. S.E.R. 24-25, 33-34. Unenrolled individuals therefore are not eligible for petitioner's services and may not receive vision-care benefits. Pet. App. 14a.

During the year 2003, petitioner's primary sources of revenue consisted of (1) administrative fees received from Administrative Service Plan subscribers, (2) prepaid vision-care charges received from contracted subscribers, and (3) interest and dividends earned on its

investment portfolio. S.E.R. 88-89. Petitioner's gross income for 2003 was $425 million (Pet. App. 18a), and its net income was $34,487,626 (*id.* at 17a). As reported on its federal income tax return, petitioner's accumulated surplus at the end of 2003 exceeded $300 million. S.E.R. 96, line 26.

Petitioner contends that its activities benefit the public in several ways. Petitioner contracts with small and rural employers who pay for petitioner's services. Pet. App. 15a. Petitioner also arranges or administers vision-care services for participants in Medicare, Medicaid, and the California Healthy Families Child Health Assistance Program (Healthy Families). *Id.* at 15a; E.R. 6. In 2003, the participants in those programs comprised approximately 41.5% of petitioner's total enrollment, and petitioner claims to have "spent $4,296,055.00 on discounts and underwritten losses" on those programs during that year. Pet. App. 15a-17a. In addition, petitioner arranges for free vision services to nonenrollees, chiefly under its Sight for Students and disaster-relief programs. *Id.* at 19a. In 2003, petitioner spent $2.8 million on services to 12,558 low-income children under Sight for Students, *ibid.*, and it provided $73,132 in disaster relief for 285 people, *ibid.* Petitioner also spent $3,893,496 on community-outreach and community-education programs in 2003. *Id.* at 21a.

Petitioner operates two for-profit laboratories that fabricate eyeglass lenses for its participating providers. S.E.R. 20-21. It also contracts with other laboratories around the United States to provide the same services. S.E.R. 20. Petitioner requires its participating providers to use its approved laboratories, including its two for-profit laboratories, when filling eyeglass prescriptions. *Ibid.* Petitioner also wholly owns a subsidiary

for-profit frame manufacturing and distribution company, Altair Eyewear, which provides frames to petitioner's participating providers. S.E.R. 53-57. During 2003, petitioner required 526 participating providers to sell frames made by its for-profit Altair Eyewear subsidiary. S.E.R. 85.

3. In 1960, petitioner was granted an exemption from federal income tax as a social welfare organization described in 26 U.S.C. 501(c)(4). Pet. App. 4a. In 1999, the Internal Revenue Service (IRS) began an examination of petitioner and ultimately concluded that, effective January 1, 2003, petitioner would no longer receive tax-exempt status under Section 501(c)(4). *Ibid.*

Petitioner filed an income tax return on its 2003 earnings, reporting and paying a tax of more than $7 million. Pet. App. 4a; S.E.R. 90. Petitioner subsequently filed an amended return requesting a refund, contending that it qualifies as a tax-exempt "social welfare" organization under Section 501(c)(4). After the IRS did not act on the refund claim during the ensuing six-month period, petitioner brought this suit for refund. Pet. App. 4a; E.R. 13.

4. The district court granted summary judgment to the government. Pet. App. 4a-25a. The court observed that, to be considered a social welfare organization under Section 501(c)(4), an entity must be "primarily engaged in promoting in some way the common good and general welfare of the people of the community," *id.* at 10a (quoting 26 C.F.R. 1.501(c)(4)-1(a)(2)(i)), rather than "carrying on a business with the general public in a manner similar to organizations which are operated for profit," *ibid.* (quoting 26 C.F.R. 1.501(c)(4)-1(a)(2)(ii)). The court concluded that petitioner's bid for an exemp-

tion did not satisfy "either of the two requisite criteria." *Ibid.*

a. The district court held that petitioner's "primary activity is not the promotion of social welfare." Pet. App. 13a; see *id.* at 11a-22a. The court observed that petitioner does not offer its vision-care plans to the general public; rather, its services are available only to employees or members of a subscribing employer, political subdivision, or other group with which petitioner has contracted. *Id.* at 13a-14a. Although the court acknowledged that petitioner "does provide services through charity programs," it found that "th[o]se services to non-enrollees are not, comparatively, substantial." *Id.* at 14a. The court explained that the $8 million petitioner spent on charitable activities amounted to only "24% of [petitioner's] 2003 net income [of $34.4 million] and an even smaller percentage of [petitioner's] gross income [of $425 million]." *Id.* at 21a. The district court therefore concluded that petitioner was not "primarily engaged in the promotion of social welfare," *ibid.*, but instead provided public benefits that were "incidental" to the "primary purpose" of "serv[ing] [petitioner's] paying members," *id.* at 14a.

b. In the alternative, the district court held that petitioner was carrying on a business with the public in a manner similar to that of for-profit organizations and was therefore disqualified from tax-exempt status under 26 C.F.R. 1.501(c)(4)-1(a)(2)(ii). Pet. App. 22a-25a. The court explained that an organization is not entitled to exemption under Section 501(c)(4) if it "devotes much of its revenues to improving its ability to compete commercially through accumulation of large surpluses and expansion of its income producing facilities." *Id.* at 23a. The court observed that, by tying bonuses to cost reduc-

tions, petitioner resembles a for-profit business. *Id.* at 23a-24a. It noted as well that petitioner "strives to remain competitive in ways that do not appear to be consistent with the operations of a non-profit," such as by paying commissions to brokers for new clients. *Id.* at 24a. The court also found it significant that bonuses paid by petitioner are "taken directly from the net earnings," and that petitioner's executives are compensated in a manner "more consistent with a for-profit corporation than [a] non-profit." *Ibid.*

5. The court of appeals affirmed in an unpublished per curiam opinion. Pet. App. 1a-3a. The court held that petitioner is not entitled to tax-exempt status because "it is not primarily engaged in promoting the common good and general welfare of the community." *Id.* at 2a. The court also observed that petitioner's own articles of incorporation state that "the primary purpose of the corporation is to establish a fund from payments by subscribers to defray and assume the costs of vision care for those subscribers." *Ibid.* The court stated that "[t]his is a purpose that benefits [petitioner's] subscribers rather than the general welfare of the community." *Ibid.* In light of that conclusion, the court of appeals did not address the district court's alternative holding that petitioner "carries on its business with the public in a manner similar to those organizations operated for profit." *Ibid.*

ARGUMENT

Petitioner contends that it qualifies as a tax-exempt "social welfare" organization within the meaning of 26 U.S.C. 501(c)(4). The court of appeals correctly rejected that argument, and its ruling (as petitioner acknowledges, see Pet. 6) does not conflict with the decision of

any other court of appeals. Further review is not warranted.

1. The courts below correctly concluded (Pet. App. 2a-3a, 11a-22a) that petitioner was not "operated exclusively for the promotion of social welfare" within the meaning of 26 U.S.C. 501(c)(4)(A) so as to qualify for a tax exemption under 26 U.S.C. 501(a). For this purpose, "exclusively" has been interpreted to mean "primarily." See 26 C.F.R. 1.501(c)(4)-1(a)(2)(i) (requiring that the organization be "primarily engaged in promoting in some way the common good and general welfare of the people of the community"); *American Women Buyers Club, Inc.* v. *United States*, 338 F.2d 526, 528 (2d Cir. 1964). Under that standard, a single nonexempt purpose, if substantial in nature, renders an organization ineligible for tax-exempt status. See *Better Business Bureau, Inc.* v. *United States*, 326 U.S. 279, 283 (1945); *Contracting Plumbers Coop. Restoration Corp.* v. *United States*, 488 F.2d 684, 686 (2d Cir. 1973), cert. denied, 419 U.S. 827 (1974); *American Women Buyers Club*, 338 F.2d at 528; *Commissioner* v. *Lake Forest, Inc.*, 305 F.2d 814, 820 (4th Cir. 1962).

An organization that operates primarily for the benefit of its members, rather than for the benefit of the community as a whole, is not exempt from tax under Section 501(c)(4). In applying that standard, a central consideration is whether the organization places barriers to membership by the public at large. For example, in *American Women Buyers Club*, the Second Circuit held that a membership organization consisting of a restricted group of female buyers of ready-to-wear-apparel was not exempt from tax, even though one of the organization's stated purposes was to promote the welfare of ready-to-wear buyers throughout the country.

338 F.2d at 527. The court explained that, as a practical matter, most of the benefits that the organization provided were for members only. *Id.* at 528.

Similarly in *Lake Forest*, the Fourth Circuit held that a membership-based nonprofit corporation that provided housing primarily for war veterans did not qualify for exempt status under Section 501(c)(4). The court noted that, although the term "social welfare" may be defined as "the well-being of persons as a community," the organization there did "not propose to offer a service or program for the direct betterment or improvement of the community as a whole." *Lake Forest*, 305 F.2d at 818. The court further explained that, although the development's playground, parks, library, and meeting halls were open to the general public, such access was not recognized "by way of dedication," but was "more through sufferance than by grant." *Ibid.* The court concluded that "[w]hatever the nature of the rights or privileges thus afforded persons other than members, it is a circumstance too insubstantial to qualify the entire activity of the corporation as in the social welfare." *Ibid.*

Likewise in *Contracting Plumbers*, the Second Circuit denied an exemption under Section 501(c)(4) to a plumbers' cooperative organized to repair damage to city streets caused by the members' activities. The court found it significant that "each member of the cooperative enjoys th[o]se economic benefits *precisely* to the extent that he uses, and pays for, its restoration services." 488 F.2d at 687. The court concluded that, because the organization provided "substantial and different benefits to both the public and its private members," it was not "'primarily' devoted to the common good as

required by even the most liberal reading of § 501(c)(4)." *Ibid.*

Thus, under longstanding precedents interpreting Section 501(c)(4), an organization's "[c]lassification as 'civic' or 'social' depends upon the character—as public or private—of the benefits bestowed, of the beneficiary, and of the benefactor." *Lake Forest*, 305 F.2d at 818. Consistent with that understanding, the courts below correctly rejected petitioner's claim to an exemption. Petitioner's operations are primarily oriented toward its private subscribers rather than toward the general public. Petitioner does not arrange or administer vision plans for the benefit of the community as a whole or even offer its plans to the general public. Instead, it contracts only with certain employers, health maintenance organizations, insurance companies, and political subdivisions. Pet. App. 13a-14a; E.R. 270. Contrary to petitioner's assertions (Pet. 4, 7, 10), the sheer number of its enrollees does not mean that it is primarily community-oriented. As the Fourth Circuit observed in *Lake Forest*, "[s]ize of membership in ratio to local population is not controlling on whether an organization is 'civic' or 'social.' The number affected is not the criterion." 305 F.2d at 816.

The fundamentally private character of petitioner's operations is manifested by several aspects of its operations. Rather than being primarily oriented toward the welfare of the community as a whole, petitioner arranges or administers plans primarily for the benefit of a narrow subset of the community, *i.e.*, the individuals, working for companies employing 1000 or more, who are a majority of its enrollees. E.R. 54. A member of the general public cannot receive benefits from petitioner unless he is an enrollee of a paying subscriber (be it an

employer, Medicare, Medicaid, or Healthy Families) or falls into the de minimis group to whom petitioner offers charitable benefits. S.E.R. 24-25, 33-34. As the district court observed, "[a] non-enrolled individual may not simply walk in off the street to receive care"; rather, petitioner's "primary purpose is to serve [its] paying members." Pet. App. 14a.

In addition, petitioner requires its participating providers (from whom its enrollees must choose) to use only approved laboratories, including its own two for-profit laboratories, when filling lens prescriptions. S.E.R. 20. In 2003, petitioner required 526 providers to sell frames made by its for-profit subsidiary. S.E.R. 50, 53-57, 85. Petitioner's governing board is controlled by representatives of its participating providers, who benefit economically from the customers directed to them by petitioner's plans. E.R. 3. Rather than primarily promoting the common good and general welfare of the community as a whole, petitioner is conducting a "privately-devoted endeavor." *Lake Forest*, 305 F.2d at 818.[1]

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[1] Also misconceived is the argument of petitioner (Pet. 22-25), joined by amici National Taxpayers Union (Br. 4-5, 10), Prevent Blindness America, et al. (Br. 6, 18-19), and Darryll K. Jones (Br. 6-7), that the denial of exempt status for petitioner's membership-based organization is inconsistent with public policy and places the exemptions of tax-exempt HMOs at risk. The determination of tax-exempt status under Section 501(c)(4) is based on an analysis of the facts and circumstances of each particular case. See, *e.g.*, *Lake Forest*, 305 F.2d at 816-820. Here, the courts below correctly concluded that private interests (those of the enrollees and subscribers) benefitted to such a degree that petitioner is not operating primarily to promote social welfare. Pet. App. 2a, 14a, 22a. That ruling was based on close examination of petitioner's own operations and will not, as petitioner contends (Pet. 24-25), jeopardize the tax-exempt status of all HMOs.

2. The district court correctly held (Pet. App. 22a-25a) that petitioner also fails to satisfy the second requirement for exempt status—namely, that it "not [be] organized for profit," 26 U.S.C. 501(c)(4)—because petitioner's primary activity is "carrying on a business with the general public in a manner similar to organizations which are operated for profit." 26 C.F.R. 1.501(c)(4)-1(a)(2)(ii); see *People's Educ. Camp Soc'y, Inc.* v. *Commissioner*, 331 F.2d 923, 932 & n.11 (2d Cir.), cert. denied, 379 U.S. 839 (1964). Although the court of appeals did not address that issue (Pet. App. 3a), the existence of that alternative ground for affirmance provides a further reason to deny review.

As explained above, petitioner's primary activity is to arrange vision-care services by connecting its paying subscribers and their enrollees to petitioner's participating providers. Such conduct constitutes ordinary commercial activity. Moreover, as the district court concluded (Pet. App. 24a-25a), petitioner conducts its operations in a manner typical of a for-profit company by paying its executives high salaries and bonuses tied to cost containment, eliminating unprofitable programs, making planned reductions in spending for charitable programs, and basing broker commissions on the revenues received from new clients. S.E.R. 51-52, 64-68, 70-73, 98, 107-112, 132, 136-138, 155-156. Indeed, petitioner had accumulated a surplus of more than $300 million by the end of 2003. S.E.R. 96.[2] Under those circumstances, as the district court correctly recognized (Pet. App. 22a-25a), a grant of tax-exempt status would give petitioner an

[2] Although petitioner asserts (Pet. 6) that it uses its accumulated surplus to improve the cost-effectiveness and quality of the vision-care services it provides, it fails to provide record references for that contention, and the record belies any such claim.

unfair competitive advantage over for-profit entities that operate their businesses in a similar manner.

3. Petitioner's assertion (Pet. 12-13) that it is a charitable entity under the common law of charitable trusts is unfounded. That issue was neither raised before nor addressed by the court of appeals, and this Court should therefore decline to consider it. See *Adickes* v. *S.H. Kress & Co.*, 398 U.S. 144, 147 n.2 (1970).

In any event, petitioner is wrong in contending (Pet. 11) that the promotion of health, standing alone, is an exempt purpose. Indeed, many for-profit entities promote health. See *IHC Health Plans, Inc.* v. *Commissioner*, 325 F.3d 1188, 1197 (10th Cir. 2003); *Federation Pharmacy Servs. Inc.* v. *Commissioner*, 625 F.2d 804, 807 (8th Cir. 1980). Contrary to petitioner's suggestions (Pet. 12-13, 19, 22), its operations are not comparable to those of the charitable HMO in *Sound Health Ass'n* v. *Commissioner*, 71 T.C. 158 (1978), acq., 1981-2 C.B. 2, or the charitable hospital in Rev. Rul. 69-545, 1969-2 C.B. 117. The findings of exempt status in those cases were premised on compelling evidence of substantial public benefit, based on community control, community-wide access to healthcare services, open medical staffing, and the provision of free emergency-room care to indigents. See *Sound Health Ass'n*, 71 T.C. at 169-172, 184-185; Rev. Rul. 69-545, 1969-2 C.B. 117. By contrast, as the courts below correctly concluded (Pet. App. 2a, 18a), petitioner's charitable activities were insignificant in relation to its overall revenue, net income, and number of persons served.

4. Petitioner contends that 26 U.S.C. 501(m), which states that certain organizations providing "commercial-type insurance" are not tax-exempt, constitutes a "savings clause" that guarantees exempt status to HMOs

that do *not* offer "commercial-type insurance." Pet. 19; see Pet. 10, 15-18. That argument was neither pressed nor passed on below, and the Court should therefore decline to consider it. See *Adickes*, 398 U.S. at 147 n.2.[3]

In any event, Section 501(m) does not grant tax-exempt status to any organization. Instead, it disqualifies an organization that otherwise meets the requirements for exempt status under Section 501(c)(3) or (4) if the organization provides "commercial-type insurance." See *Nonprofits' Ins. Alliance of Calif.* v. *United States*, 32 Fed. Cl. 277, 292 (1994) ("Congress enacted section 501(m) to restrict, not enlarge, the scope of organizations that qualify for tax-exempt status."); accord *Florida Hosp. Trust Fund* v. *Commissioner*, 103 T.C. 140, 150 (1994); *Paratransit Ins. Corp.* v. *Commissioner*, 102 T.C. 745, 755 (1994). Thus, even if petitioner could show that it does not provide "commercial-type insurance," it would not be entitled to a tax exemption because it does not satisfy the basic requirements of Section 501(c)(4).

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[3] Petitioner's new reliance on Section 501(m) also raises a question as to this Court's jurisdiction to decide that challenge. Petitioner did not invoke Section 501(m) in its administrative-refund claim but rather relied solely on Section 501(c)(4). See *United States* v. *Felt & Tarrant Mfg. Co.*, 283 U.S. 269, 272-273 (1931).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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